The Retreat of the Emerging Markets*

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What a difference a year makes. Even until just a year ago, the "emerging market economies" were being lauded as the hope of global capitalism. They were supposedly able to "decouple" themselves from the financial crises and stagnation of advanced economies because of their growth potential in the form of "catching up" and by dint of their demography, which meant younger populations. Newer groups of countries were identified according to shifting perceptions of their future potential, from larger countries like the BRICS (Brazil, Russia, India, China, South Africa) to the MINTs (Mexico, Indonesia, Nigeria, Turkey) to other smaller economies that were still seen as attractive because of their dynamism.

This apparent dynamism contrasted sharply with the secular stagnation that seemed to have gripped advanced capitalism, creating a "new normal" or even what the IMF has called "the new mediocre" of low and spluttering growth of economic activity with even lower growth of employment. Along with the differences in economic potential and the very different rates of growth of national income that were evident, there was also the widespread feeling of the changing global balance of economic power, with the countries of developed capitalism –the US, Europe and Japan–ceding power to some of the more prominent developing countries, and China in particular.

In the eyes of global investors and their cheerleaders in the financial media, for a while it seemed that the emerging markets could do no wrong, and they certainly became destinations for hot money flows at a time when loose monetary policy in the US and Europe had rendered real interest rates close to negative there. The optimism continued even when both the global economy and the important economies of the developing world were already indicating signs of weakness and output slowdown.

When realization finally hit the markets and financial analysts, it hit with a clamour. Now the discussion has turned completely, and the same countries that were earlier seen as full of growth promise are suddenly decried as replete with economic problems that are only going to get worse, and likely to be facing serious downturns. Problems of falling exports and slowing domestic economic activity are being compounded by capital flight from these countries, amounting to more than $1 trillion in the past year. And this has occurred even before interest rates in the United States have been raised, as they are expected to be in the near future.

So what actually happened? Actually, neither the over-optimistic narrative of the recent past nor the current despair about their future prospects captures the reality of most of these developing countries. The truth is that the economies of the South, or emerging markets, were never "decoupled" from the North in their period of rapid expansion. Rather, their GDP growth was based on a strategy of increasing exports that finally depended on developed country markets, even as it generated much more trade between developing countries, and on capital inflows that stemmed from global economic changes.

The quintessential example as well as the eventual lynchpin of this strategy was the Chinese economy. The combination of progressive opening up of the state-controlled economy with large increases in public spending on infrastructure and very determined export orientation generated dramatic increases in export volumes that in turn enabled very robust GDP growth over more than two decades. These exports were largely directed to the countries of the developed North, although they also increased to every region, such that China became the most important trading partner for the majority of countries, even those that were geographically distant.

In the process China also became the engine of growth for many other developing countries through its ever-increasing demand for raw materials and intermediates. Both primary commodity exporters and manufactured exporters benefited from this process in terms of increasing exports, as intricate value chains developed linking different areas and regions. As the economies grew, they also attracted more and more private capital flows, thereby further adding to the economic boom, and enabling many of these countries to "emerge" through much higher rates of income growth than in the advanced economies.

This process of export-led growth was not without its limitations. The idea was to rely on ever-increasing external demand based on rising shares of global markets. Since all developing countries were focused on export-led growth as the desired strategy (even those who were less successful at it) the competitive pressure was intense. The emphasis on external markets led both producers and policy makers across the developing world to view wages as a cost rather than as a source of potential demand, and generated all sorts of strategies to reduce unit wage costs. Wage shares of national income have declined across the world, but particularly in developing countries. In turn, economic inequalities grew within countries, especially the more successful ones. The process was also associated with substantially increased environmental problems, as the urge to produce more and to produce it as cheaply as possible led to over-exploitation and degradation of nature. Because most countries were simultaneously opening up capital accounts and deregulating domestic financial markets, they rendered themselves more susceptible to hot money flows that could in turn generate boom and bust cycles, independent of the real economic processes. All of this meant that this strategy was ultimately unsustainable, although when that "ultimately" would occur was of course open to question.

The financial crisis in the US in 2008 and the subsequent Global Recession in 2009 provided the first major shock to this process. It is widely believed that developing countries weathered the global crisis rather well despite the precipitous decline in exports in 2009, and this is taken as proof of their resilience and "decoupling" from the growth tendencies in the North. But this is a misinterpretation. The most important economies – especially China – were able to weather the storm because they put in place substantial recovery packages designed to prop up domestic demand. However, the focus in China was not on increasing consumption, so much as on fuelling more investment demand through higher public investment (especially by provincial governments and state owned enterprises). So, in a context of past over-accumulation, the emphasis was on creating even more capacity, and that too with investment financed through debt.

In other developing countries too, any shift to domestic demand was generally not based on increasing wages and employment (other than in some Latin American countries) since that would threaten the export-driven model by increasing wage costs relative to competitors. Rather, the focus was on debt-driven expansion even for household spending, particularly on real estate and consumer durables. Across developing Asia, for example, the period after the global crisis has been characterised by real estate bubbles driven by debt creation. Ironically, therefore, developing countries sought to rely less on Northern markets by reproducing their unsustainable economic strategies: the same policies that had led to the housing and real estate bubbles in the US and UK, for example. In many of these countries, the unwinding of these bubbles had already begun well before this was recognised by global investors.

In China too, the real estate bubble and related construction boom were actively encouraged by the government, even though the resulting expansion and asset price rises were well beyond anything that could be justified by real economic variables. When that (inevitably) petered out, leaving large debt overhangs for public and private agents, growth was sought to be instigated once again by pushing up the stock market. Various monetary policy measures were brought in and financial regulations were eased so as to actively promote the market for A-shares that can only be purchased by Chinese investors. The frantic attempts to shore up the stock market after its mid-June collapse were destined to fail, but that unwinding will also have a deflationary impact. But the behaviour of the stock market in itself is less relevant than the broader point that this additional attempt to sustain domestic growth without abandoning the export-led model has also failed.

In the last year, the slowdown in demand from developed country markets has made itself felt ever more painfully across the developing world, as it affects production in China and therefore indirect demand for exports of other developing countries. Primary producers are clearly feeling the pain, with prices dropping dramatically along with declining import volumes. Economies dependent on oil exports or other primary goods exports are all facing slowdown or declining incomes, and in some case domestic political turmoil as a result. But manufactured goods exporters are also badly affected. The interlinkages between different regional production centres are now so strong that these negative impulses not only have adverse domestic consequences through internal multiplier effects, but they also generate negative feedback loops across countries.

In such a context competitive devaluations will only exacerbate the problem. Already it is clear that exchange rate changes are causing changes in the trade balance mainly through declining imports rather than rising exports, causing an aggregate deflationary tendency. Chinese imports have declined much more precipitously than Chinese exports, and this is also true for a number of other exporting countries – so global imbalances do not really improve through this means. Meanwhile, finance is a fickle as ever, rushing out of countries to a degree completely unwarranted by current or expected real economic tendencies and thereby making things much worse.

All this is made even more complicated by the fact that recent trade deals (both multilateral and regional) have essentially worked to liberalise the trade in goods and services in terms of the production phase, but have tightened monopolies in the pre-production phase through the control over knowledge in the form of intellectual property rights like patents and industrial designs and in the post-production phase through more enforcement of branding and marketing power. So, even insofar as global trade continues to limp along, the value added in such trade will be concentrated in the developed economies while developing economies battle it out over the meagre spoils to be had in the low value segments.

So what does this mean for emerging markets? Is the party really over? That really depends on whether these countries can change their growth strategy away from export dependence and reliance on financial bubbles to generate economic expansion, and move instead towards domestic wage- and employment-led growth. The current model has clearly run its course, and is now leaving financial, economic and ecological devastation in its wake. Of course this change in strategy requires more than the getting of wisdom among policy makers – it requires changes in political economy that do not seem immediately likely in many countries. But for the party to continue at all, the theme clearly has to change.

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